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March 1, 2004

VIA HAND-DELIVERY

Mary L. Cottrell, Secretary
Department of Telecommunications and Energy
One South Station
Boston, MA 02110

Re: D.T.E. 04-01 - Investigation Regarding the Assignment of Interstate Pipeline Capacity

Dear Secretary Cottrell

Enclosed for filing in the above-referenced docket are the Initial Comments of Bay State Gas Company ("Bay State"). Bay State is filing these comments in response to the Order issued on January 12, 2004, by the Department of Telecommunications and Energy ("Department") requesting comments on whether the upstream capacity market is sufficiently competitive to warrant the Department to allow voluntary capacity assignment by gas companies to other entities.

Please do not hesitate to contact me with any questions. Kindly date-stamp a copy of this letter for our files and return it to us in the enclosed envelope.

Thank you for your attention to this matter.

Very truly yours,

Patricia M. French

cc: Caroline M. Bulger, Hearing Officer (1 copy)
Andreas Thanos, Assistant Director, Gas Division (4 copies)

COMMONWEALTH OF MASSACHUSETTS

DEPARTMENT OF TELECOMMUNICATIONS AND ENERGY

INITIAL COMMENTS

OF

BAY STATE GAS COMPANY

D.T.E. 04-01

MARCH 1, 2004

I. INTRODUCTION

In its order issued January 12, 2004, the Department of Telecommunications and Energy ("Department") sought comments on whether the upstream capacity market is sufficiently competitive to warrant the Department to modify its currently-approved mandatory approach to capacity assignment. See, *Order Opening Investigation Regarding the Assignment of Interstate Pipeline Capacity*, D.T.E. 04-01 (Jan. 12, 2004) ("Order"). Bay State Gas Company ("Bay State" or "Company") respectfully submits these comments in response to the Department's request.

Bay State's comments are arranged as follows. In Section II, Bay State explores the historical premise of competition nationally and in Massachusetts, as well as its participation in the earliest moves towards unbundling and retail competition, which set the groundwork for the 2004 market conditions. Bay State also describes and analyzes natural gas markets including the physical operational and demand complexities in current capacity planning that create potential risks for system reliability. In Section III, Bay State addresses particular issues that it sees as germane to the Department's evaluation of the capacity planning and assignment and associated issues including the overall competitiveness of upstream capacity markets, and evaluates the issues for which the Department specifically sought comment. Finally, in Section IV, Bay State summarizes its recommendations in conclusion for the Department.

Bay State has examined the many changes in the natural gas industry since the early 1980s and has compared that level of transition to the growth of the competitive retail market since such efforts were undertaken as a result of the Department's unbundling orders beginning

in 1998. In spite of the tremendous optimism with which markets and services were opened, many of the expectations associated with competition have not materialized. There exist institutional, economic and market-related impediments on both a local and regional level that make it unlikely that voluntary capacity assignment will bring any consumer benefits and may well present risks to system reliability**.** Capacity planning and acquisition should remain the responsibility of Massachusetts local distribution companies ("LDCs"). In sum, the upstream capacity market is not sufficiently competitive to support voluntary capacity assignment. Nevertheless, Bay State suggests the Department establish guideposts for its continuing review of the market into the future, so at the time the market becomes sufficiently mature and self-sustaining, the Department can adopt the appropriate mechanisms to further its development.

II. DESCRIPTION OF CURRENT MARKET CHARACTERISTICS

A. Introduction

Natural gas markets continue on a course of broad restructuring that began over twenty-five years ago with the initial deregulation of most wellhead prices. Through a series of further physical infrastructure improvements, as well as financial market, regulatory and technological advances, the manner in which gas supplies are traded and delivered to end-use customers has been completely transformed. The result is a dynamic and competitive marketplace that is capable of delivering greater value to customers. These changes affected every facet of the gas industry from producers to pipelines to distributors to customers.

The appropriate rules for capacity assignment by LDCs to third-parties must be considered in the context of market circumstances in each segment of the industry. The status

and evolution of retail and wholesale gas markets bear upon the ability of regulators and market participants to plan and provide for continued reliability and affordability of gas service for retail customers. Upstream capacity assets are instrumental to the reliability of service in Massachusetts and the structures and responsibilities for their acquisition and disposition must continue to be thoroughly evaluated. The Department's inquiry in this proceeding is appropriately focused on the current level of competition in capacity markets as this is a core issue to the capacity assignment approach.

B. Summary of Section

This section of Bay State's comments reviews the current status of wholesale and retail markets to provide the basis for evaluating the Department's mandatory capacity assignment policy. The section begins with a review of Bay State's unbundling experience including an account of the present competitive retail activity and important trends over time. The Company believes that the lessons learned from its unique experience with retail unbundling based on both voluntary and mandatory capacity assignment frameworks are particularly valuable to the Department as it conducts its review of the approach to capacity assignment. In addition, wholesale market conditions are reviewed with an emphasis on changes since the Department's 98-32B Order and on market conditions in New England, which are different than in other areas of the country. Lastly, capacity planning responsibilities under existing Department policies are discussed.

C. Bay State Unbundling Experience

1. Bay State PVCC Pilot Program

Bay State was an early proponent of competitive retail markets consistent with the direction provided by the Department in the early 1990s. Competitive services were initially offered to commercial and industrial ("C&I") customers pursuant to daily-metered tariff services. Bay State subsequently promoted the development of an aggressive non-daily metered residential pilot program in 1996, which was later expanded in 1997. The program terms were designed in a collaborative environment that enjoyed broad participation by local stakeholders as well as national marketers. Notably, residential and C&I customers participating in the Pioneer Valley Customer Choice ("PVCC") pilot program were permitted to migrate to transportation without mandatory assignment of upstream capacity. During this period, Bay State was the only LDC in New England and one of a handful nationwide that offered transportation service options to residential customers.

Bay State was, by all accounts, seeking to bring the benefits of competition to its customers at a more rapid pace than any other LDC in the region and initial successes were achieved. The pilot program required substantial capital and resource investments in new processes and systems as well as customer communications to ensure its success. Many lessons learned during this early implementation of customer choice for small volume customers guide the Company's continued commitment to deliver the benefits of competition to all of its customers and to respond to changing market conditions.

While there have been recent changes in wholesale and retail markets generally, Bay State's own experience as an early and strong proponent of the development of competitive retail

markets for its customers has placed it in the position of having had several years of experience with customer choice. Bay State's unbundling experience includes real-world examples of both voluntary and mandatory approaches to capacity assignment.

Bay State's PVCC pilot program and its other transportation programs did not require suppliers to acquire capacity in order to serve the Company's customers prior to the Department's Order in D.T.E. 98-32B *(*the *"1999 Capacity Order")* instituting a policy of mandatory capacity assignment. In fact, the majority of suppliers chose to utilize their own capacity to serve customers rather than accept voluntary assignment of Bay State's capacity. Pursuant to the rules implementing the Department's mandatory capacity assignment program, all customers that migrated to transportation prior to February 1999 without LDC capacity were grandfathered and retained an exemption from the assignment of capacity as long as they remained on transportation service. The early success of Bay State's PVCC pilot program resulted in circumstances that were unique among other LDCs in Massachusetts. At the time of the *1999 Capacity Order* other LDCs did not have much, if any, grandfathered load on their systems creating a significant distinction between Bay State and other Massachusetts LDCs.

2. Grandfathered Customers and Reverse Migration

By virtue of the fact that Bay State promoted unbundled services to its customers and potential suppliers during the early stages of retail unbundling, it had a significant number of grandfathered customers. This fact, coupled with more recent market changes affecting the level of supplier activity and the types of services being offered by competitive suppliers, has subjected Bay State to a substantial reverse migration of customers from transportation service to default service since the spring of 2000. The reverse migration has included thousands of

customers who were grandfathered and returned without the capacity rights necessary to serve them. Because the number of customers purchasing gas from third-party suppliers was greater on Bay State's system than for other LDCs (as a result of its early unbundling efforts), this phenomenon was not being experienced to the same degree by any other Massachusetts LDC.

The resource planning implications of customers returning to bundled default service are material. As a result of Bay State's supplier-of-last-resort role, a role that was affirmed by the the Department in the *1999 Capacity Order*, Bay State is aware that it may be called to serve not only its existing bundled sales service customers but returning transportation customers as well.[1] Because these customers rely on Bay State capacity on a moment's notice and because these customers have a high demand for natural gas service, Bay State must maintain sufficient flexibility to meet the capacity requirements necessary to satisfy the inevitable obligation. Due to the significant proportion of grandfathered load on Bay State's system, the resource planning flexibility required by Bay State to carry out its responsibilities is unique among gas companies under the Department's jurisdiction.

At the present time, approximately 1.1% of Bay State's total firm customers (309,279) are transportation customers (3,392). These transportation customers comprise 25% of Bay State's total residential, commercial and industrial firm load (excluding only electric generation load), more than any other LDC. Letter to Department, Feb. 2, 2004 (customer data for period 1/1/02 through 10/31/03). The disparity between these percentages indicates that competitive options have narrowed and are now primarily available to Bay State's larger customers; however, this wasn't always the case. Id. Figure 1 examines these data series over time from the

[1] Bay State's bundled sales service customers are identified in the Model Terms and Conditions (D.T.E. 98-32-D) as default service customers, and will be called "default customers" throughout this document.

inception of Bay State's pilot program to the present. The number of customers transporting rather than taking default service rose to a peak in April of 1998 and then began declining in the summer of 1998 to today's levels. See Figure 1. For the two-year period 2001-2002, the number of Bay State customers transporting their gas needs remained relatively constant and then over the past year (2003), Bay State has experienced an additional gradual decline in the number of transportation customers. Further, the average size of transportation customers has increased over the years, as small volume customers first migrated to transportation service and then migrated back to default service. Illustrative of this trend is that for the 12-months ending 1998, the average annual load per customer of Bay State's transportation customer segment was approximately 6,700 therms, while today (12-months ending October 31, 2003), the average use has increased to 34,800 therms per customer .

Marketers serving Bay State customers have experienced intermittent delivery failures where Bay State has been required to make up marketer shortfalls. Therefore, the daily operations performance of marketers has not been as reliable as the market requires or as reliable as Bay State's own portfolio operations. During January 2000, marketers incurred approximately $1.5 million of penalties for failure to stay within required tolerances when Bay State's pipeline suppliers issued operational flow orders ("OFOs"). Significant penalties have been incurred by marketers for failure to make adequate deliveries over the last four years, particularly during cold snaps, and such penalties (while completely necessary to a properly functioning market) may well cause some marketers to exit the retail business in Massachusetts, leaving the obligation to serve those customers to Bay State once again.

Although the current status of retail unbundling in Bay State's service territory presents

challenges for the Company from a resource planning perspective, Bay State remains committed to deliver the maximum benefits of competition to all of its customers. Bay State's commitment includes its desire to continue facilitating competitive opportunities for its customers in markets of interest to suppliers. In addition, Bay State commits to continue to promote the adoption of transportation service by new customers, which is an area in which the Company has recently achieved some degree of success over the years.

3. Grandfathered Customers and Capacity Planning

Supplier failures have created a significant turnover in those suppliers serving Bay State's markets. The result is substantial numbers of customers seeking default service from Bay State on short notice as those suppliers exit the market. The number of active suppliers available to serve Bay State customers peaked at 32 in early 1998, but has declined to nine today. Moreover, the bulk of the transported load is centralized in just a few of those nine marketers. Even among the nine, two have less than six months experience on Bay State's system. The median time period for all suppliers that have done business on Bay State's system is less than two and one-half years out of eight-plus years of data. Figure 2 provides a graphic depiction of the duration of each marketer's active status serving Bay State customers. In many respects the active supplier list can be characterized as a revolving door, which is undesirable for customers and the market, because financial instability dissuades broader customer participation.

While many of the changes in natural gas markets discussed earlier brought greater competition and customer choice, they invariably introduced considerable uncertainty in the LDC resource planning process. In particular, Bay State's continuing role as supplier-of-last-resort for retail customers complicates the manner in which it is able to forecast demand and

design its resource portfolio. As the Department recognized in the *1999 Capacity Order*, unlike electricity markets, for example, gas markets do not have centralized bodies such as power pools or independent system operators that can effectively take responsibility for regional reliability. With the introduction of competition from marketers, the LDC is nevertheless responsible for ensuring the overall reliability of gas supply on its system, and because of the physical interconnectedness of its distribution system, must meet the sudden demand of any retail customer served by its distribution system who is without gas supply for any reason. Bay State agrees with the Department's earlier finding that this role is appropriately vested in the LDCs at least until such time as upstream gas markets are sufficiently robust that they "can be relied upon for the provision of reliable, low-cost gas deliveries." Id.

Capacity markets serving Massachusetts cannot be characterized as robust. Therefore Bay State must continue to plan its portfolio of resources to ensure adequate and reliable supply at all times, or risk impairing service to its firm customers. While Bay State continues to participate actively in industry restructuring activities and to monitor the status of market developments in wholesale and retail markets, the reality of the sudden, physical operational use of Bay State's system and planned capacity by transportation customers who lack designated upstream capacity creates critical uncertainties in reliability and cost for Bay State and its firm customers.[2] Bay State's role as supplier-of-last-resort is complicated further by its early promotion of competition that resulted from its understanding of the benefits to consumers available from competitive markets. As discussed further below, the early migration of Bay State customers to transportation meant they did so without mandatory capacity assignment,

[2] These uncertainties are magnified during peak demand periods such as was experienced this past January when supplies were extremely tight and city gate prices in New England were over $60.00 per Dth.

which now creates a planning quandary should these customers return to default service to any measurable degree. Moreover, the unplanned use of Bay State's system resources by such customers jeopardizes system reliability. Mandatory capacity assignment assured that customers who migrated after the effective date of the *1999 Capacity Order* now return with adequate capacity to be served by Bay State due to the Department's requirement that LDCs release capacity to marketers with recall rights.

D. Wholesale Market Attributes and Trends

During much of the 1990s, natural gas prices remained fairly stable and relatively low by historic measures due to the surplus capacity overhang typically referred to as the "gas bubble." While pipeline transportation was constrained in some areas, such as New England, other areas benefited extensively from the readily available market supplies and pipeline capacity to cost effectively access these supplies. As the 1990s ended, demand growth had outstripped the new supplies, taking up much of the available slack that had existed between supply and demand levels.

At the same time, Federal and State regulators and legislators lead the country toward a more market-based structure, inviting many new purchasing opportunities, opening actively-traded physical and financial gas markets, and providing needed transparency on market price data. The impact of these changes was even further magnified by technological advances that opened up new channels for transacting business.

With the closer balance between supply and demand currently existing and with the greater emphasis on competitive market structures, natural gas markets have continued to evolve since the Department issued the *1999 Capacity Order*. An understanding of current market

fundamentals is relevant to the Department's current inquiry concerning capacity assignment.

Price volatility, a result of changing market fundamentals, has become much more pronounced since the the *1999 Capacity Order* was issued. Volatile natural gas prices result from a tightening supply-demand balance and the manner in which additional supplies are brought to market. As the Department knows, demand for natural gas is highly elastic depending on weather, economic conditions and energy policy. Demand response can also change significantly when significant new load is added, as is the case when new gas-fired electric generation is connected to the region's electric grid. It is well known that environmental policies presently favor the use of gas in new generation, with natural gas accounting for approximately 90% of all new electric generation capacity[3] as a result.

Similarly, the supply response is much slower than the demand response creating localized and regional constraints from time to time. These are due to the need to construct infrastructure to deliver commodity supplies to markets, and also as a result of delays in bringing on incremental production capability. The lead time for additional incremental pipeline capacity is typically three years, depending on the nature of environmental issues and the need for regulatory review.

Since the Department's *1999 Capacity Order*, market liquidity has been measurably reduced. Producer consolidation has reduced the number of parties that can act as counter-parties. In addition, more stringent creditworthiness standards in gas markets have contributed to the number of competing wholesale marketers.

Bay State believes that a proactive approach is required to assure safe and reliable service

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[3] American Gas Association, *Avoiding the Wild Ride: Ways to Tame Natural Gas Price Volatility* at 10 (Nov. 2003).

in the face of the growing demand-supply imbalance.

E. Regional Capacity Market Issues

Prior to 1999, Massachusetts gas markets were served primarily off three pipeline systems: Algonquin Gas Transmission ("Algonquin"), Tennessee Gas Pipeline ("Tennessee") and Iroquois Gas Transmission. In addition, Distrigas was and still is a significant supplier of LNG. Distrigas supplies are normally off-loaded from tankers at the Distrigas terminal in Everett, Massachusetts and delivered to Massachusetts markets primarily via backhaul on Tennessee or Algonquin or via trucks carrying liquid to storage tanks throughout the Commonwealth.

More recently, two additional pipeline projects are providing incremental supplies to the region: Portland Natural Gas Transmission System ("PNGTS") and Maritimes and Northeaast Pipeline ("Maritimes").

Upstream capacity markets have been constrained historically in the New England region, because of rapid demand growth and long intervals between major incremental pipeline projects. Massachusetts has neither production capabilities nor local market area storage as a tool to offset potential capacity constraints. A number of market indicators attest to the lack of liquidity in capacity markets even as two new pipeline projects have added deliverability to the region.

The incremental pipeline capacity in New England has been fully subscribed by gas-fired electric generation and traditional residential and C&I gas markets. Close to 10,000 MW of new gas-fired electric generation has been added to the New England electric grid in the last five (5) years alone. The region's increased reliance on natural gas to generate electricity is evidenced

by the quantity of gas used to generate electricity in the region, which was 180 Bcf in 1999 and 340 Bcf in 2002, an increase of 160 Bcf or 88%.[4] To place this in perspective, Bay State's SENDOUT for 2003 was only 52.4 Bcf.

Basis differentials also point to a lack of liquidity in New England gas markets.[5] Basis differentials provide an indication of the difference between supply availability in the production area and in the market area. Basis differentials are primarily affected by the availability of needed infrastructure to deliver supplies from production areas to market areas. During the recent cold snap this past January, basis differentials between the NYMEX and New England markets reached levels not experienced before. When the New England basis differentials are compared to the Chicago market area for the same period, it demonstrates that the Chicago market offers more liquidity. In fact, the Chicago city gate prices often traded below the NYMEX cash market. See Figure 3.

The Department has approved a number of incremental capacity additions since the *1999 Capacity Order*, including Bay State capacity additions on PNGTS, Algonquin and Tennessee. The capacity additions continue to reflect tight market conditions with pipelines requiring minimum terms of at least ten years. Furthermore, primary capacity rights remain concentrated with LDCs and electric generators, which are the entities with long-term commitments to their respective markets.

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4 Energy Information Administration, *Natural Gas Annual* (2002).

5 Basis differentials are the difference between a NYMEX price and a market area price for deliveries occurring over the same period. The NYMEX cash and futures markets provide an indication of the supply-demand balance in production areas. Tight supplies created through increased demand or cold weather contribute to higher NYMEX prices

F. Current Capacity Planning Responsibilities

In Massachusetts, an LDC is still obliged to provide service to all customers actively served by its distribution system, given the uncertain future of any movement toward a more competitive regulatory framework and the importance of ensuring continuity of reliable gas service. *1999 Capacity Order*, at 9. Moreover, LDCs are committed to their customers: more customers drive revenues and higher demand benefits ratepayers as the fixed capital costs of providing service are spread over more customers. Bay State advocates that the LDC's capacity planning role be reviewed again by the Department as the Department evaluates whether the Massachusetts retail market is sufficiently competitive to make any reduction in supplier-of-last-resort obligations feasible or warranted. Under current regulation, Bay State must continue to serve and to maintain a portfolio of resources consistent with that obligation. 220 C.M.R. 14.03(4)(a); *1999 Capacity Order* at pp. 41-42 (during first three years of transition, LDCs must plan and procure capacity to serve all firm customers; recognized role as supplier of last resort in event of marketer failures).[6]

As indicated earlier, customers who migrate to transportation service following the Department's *1999 Capacity Order* were required to accept assignment of Bay State's capacity resources. Therefore, as these customers return, Bay State automatically reacquires capacity that was previously assigned to the supplier. It is the uncertainty associated with planning for customers who migrated before the *1999 Capacity Order*, for whom Bay State risks a capacity shortage should they return to default service, that creates vast planning complexities for Bay State. On the one hand, a long lead time is needed to obtain new capacity to Bay State's

[6] Bay State is in the process of evaluating an Order recently issued in D.T.E. 02-75 concerning the Company's most recent Integrated Resource Plan that addresses the Company's capacity planning activities.

citygates, especially in the case of long-haul capacity, but on the other, often very little advance notice is given to Bay State regarding the timing or size of returning customers.

In addition, Bay State recently encountered difficulties in complying with the *1999 Capacity Order* and assigning capacity to some marketers because these marketers failed to meet the creditworthiness standards on some of Bay State's upstream pipelines. Bay State expects that the pipelines' creditworthiness standards will become increasingly stringent to reflect the increasing financial risks in the energy industry. Tougher creditworthiness thresholds will create a "credit crunch" that is likely to put added economic pressure on retail marketers and their wholesale partners. Ultimately, this creates barriers to participation in the market and could elicit further marketer failures, leading to even more significant reverse migration to Bay State default service.

III. KEY QUESTIONS RELATED TO THE DEPARTMENT'S CAPACITY ASSIGNMENT POLICY

Capacity assignment issues directly reflect the tension between achieving cost savings and preserving reliable service. Bay State poses here a number of questions which it sees to be at the core of any evaluation of capacity assignment in a competitive marketplace, including: the role of system reliability, the impact on customers in terms of expectations in cost and service, the appropriate roles of the various market players, and how best to establish the conditions (if at all) that will serve to promote the development of a more viable competitive market. Bay State also addresses the issues for which the Department specifically sought comment. Examination of these core issues is germane to the policy decisions now facing the Department as it examines its existing policy on capacity assignment. While markets remain in transition, the actual market

experience gained since the Department's *1999 Capacity Order* removes a good deal of the uncertainty that faced the Department when it initially tackled these issues. Therefore, it is Bay State's hope that its analysis of the current wholesale and retail market environment discussed previously may set the stage for the responses provided below.

Have expectations concerning the development of competitive retail markets changed since the 1999 Capacity Order?

At the time of the *1999 Capacity Order,* most industry participants and stakeholders anticipated that retail competition for all gas customers was on the doorstep in Massachusetts and elsewhere. The restructuring of retail gas markets followed closely the restructuring of the production function in the wholesale markets and the restructuring of interstate pipeline transportation and storage services.

Prior to the *1999 Capacity Order,* retail restructuring had progressed stepwise beginning with the unbundling of interruptible services through to the unbundling of firm services for large C&I customers. The next logical action in this progession was the restructuring of small volume firm markets and the Department, to its credit, charted a path designed to promote the development of sustainable competitive markets for all customers.

Through Bay State's PVCC pilot, Bay State was able to maximize its own understanding of competitive markets and to enhance its ability to respond to future market uncertainties. The PVCC pilot was successful by many measures, including customer and marketer participation. Most importantly, it provided stakeholders with actual experience observing competitive market behavior in small volume gas markets. The success of Bay State's residential pilot program and others that occurred during that same time period influenced those early expectations concerning

the impendency of full retail competition.

High expectations for competition in electric generation markets were also evident as the Commonwealth opened electric markets to a measured transition to competition less than a year earlier. Some markets in Massachusetts were among the first where customers could choose a third-party supplier to meet both their electric and gas needs, a key characteristic that drew potential suppliers into the market. The enthusiastic welcome provided the combination of restructured retail electric *and* retail gas markets in Massachusetts that influenced expectations that competition in both markets would flourish.

The optimism was not long held. Since then, a number of key events combined with a precipitous decline in competitive activity in energy markets has resulted in a normalizing of both the pace and the expectations of the transition. While many large customers have been and continue to realize benefits from competition, questions remain regarding the end-state of competition for small customers.

Numerous key events over the past five years shape Bay State's view of the viability of natural gas competition for small customers. First, the itinerant failure of the restructured California electric industry in 2000 and 2001 led to significant price increases for customers as California took action to shore up reliability concerns with a host of expensive long-term generation supply contracts. California was early to promote retail market deregulation and as a result of the catastrophic economic failure of its competitive market experience, a rollback of deregulation altogether remains a part of current public discourse. While the Massachusetts' model for competition is light-years from California in design, California's painful lesson is not lost on businesses, utilities, legislators or regulators anywhere else in the United States and

clearly encourages a cautious and managed approach to market transition. Quite simply, newly competitive markets need careful attention and ample time to grow.

The second significant event was the rapid rise and collapse of energy giant Enron in 2001, the largest corporate failure in U.S. history. Not only was Enron a strong proponent of competition, active in regulatory and legislative circles across the U.S., it was a dominant trading firm in natural gas markets. Because of Enron's status, Enron's failure resulted in a shock to consumer confidence in deregulated and wholesale markets, even though the true cause for Enron's failure related ostensibly to insider fraud and patently to continuing grossly overstated assessments of its success. Another outflow from the Enron crisis, creditworthiness standards have increased and access to capital has decreased for competitive suppliers. Each of these events has revised the pace of market transitions -- previously believed to be inevitable -- to a slow, and sometimes backwards crawl.

Accordingly, the level of market and regulatory activity related to competitive retail services has declined dramatically since 1999. Companies with national retail plans have exited markets as business plans have changed and smaller regional marketers have come and gone. National trends are borne out by Bay State's own experience described earlier. Presently, nine marketers are serving Bay State customers, while 32 were doing so at a peak in early 1998. In the past, marketers with divergent business models and plans for market penetration served Bay State's customers, while most marketers today are niche marketers focused on larger C&I accounts. Similarly, where many jurisdictions were devoting considerable resources to developing unbundled tariffs and other mechanisms to support competition in previous years, there is much less of this activity today.

Expectations concerning market development are vastly diminished: the challenges to acquiring and serving small-volume customers were greater than anticipated, and small customers were more apathetic than expected, failing to embrace competition. Whatever the underlying reasons, competition is not likely to expand in Massachusetts.

Have FERC initiatives affected the competitiveness of capacity markets?

The FERC plays a critical role influencing the direction and structure of capacity markets throughout the U.S. While FERC continues to promote the advancement of competitive markets, events of the past few years have presented a number of challenges to federal regulators including gas and electric supply issues in the West, financial price reporting issues, and the far-reaching blackout of August 2003. As a result, FERC has increased its emphasis on developing adequate infrastructure for ensuring reliability, fair price reporting and the financial stability of markets. See, e.g. FERC Strategic Plan 2004-2008. Nevertheless, a number of important matters affecting capacity markets have been addressed in recent years by FERC.

FERC lifted the price cap on short-term capacity releases for periods of less than one-year beginning in February 2000.[7] This provided additional opportunities for shippers to offset fixed costs through any releases that exceeded maximum pipeline rates during peak periods. However, because this initiative focused on short-term markets, it does not measurably impact the liquidity of primary capacity markets.

FERC also modified its right-of-first-refusal ("ROFR") rules regarding the ability for pipelines to maximize the value they obtain from capacity renewals. Previously, primary capacity holders, which are mainly LDCs, only needed to match the pricing terms of a competing

[7] FERC Order No. 637, 65 FERC 10,156.

offer for capacity it seeks to renew for a period of five years. The FERC recently eliminated the ROFR term-matching cap altogether in response to a court victory in a battle waged by interstate pipelines. The change has far-reaching ramifications for LDCs who must evaluate whether to match competing offers for capacity renewals that exceed five years.[8] The modification of this important capacity renewal policy provides pipelines with the opportunity to file to modify their existing tariffs to accommodate the elimination of the cap. To the extent that pipelines serving New England implement this change, Bay State believes that this change strengthens their negotiating leverage in capacity renewal situations, thereby creating additional contracting risks for LDCs.

In response to the financial collapse of large trading organizations including those run by Enron, pipelines sought to tighten their tariffed creditworthiness standards applicable to primary and secondary shippers.[9] The FERC recently opened a rulemaking proceeding into the standard creditworthiness provisions in FERC Docket No. RM04-4. The changes approved by FERC in response to this effort, while understandable from a pipeline view, have an unintended retail impact by contributing to a reduction in counter-parties and difficulties for some retail suppliers in accepting Bay State's capacity releases.

FERC is embarking on the implementation of a standard market design ("SMD") for the electric industry that Bay State believes will likely have spillover effects on gas markets. The SMD approach would affect the siting of electric generation and create changes in transmission pricing. The market response of gas-fired electric generation to these changes could either

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8 Rulemaking, *Order on Remand*, FERC Docket No. RM98-10,101 FERC 61,127 (2002).

9 See, e.g. Tennessee Gas Pipeline Co., 100 FERC 61,268 (2002)

increase or further limit the competitiveness of capacity markets in New England.

In sum, FERC's initiatives over recent years have neither assisted in nor acted as a deterrent to a workably competitive upstream capacity market. But neither have these initiatives encouraged the building or financing of capacity projects without long-term dedicated purchasers of that capacity. In order to get a capacity project financed, project financiers require a dedicated market to take that capacity. Finally, in Bay State's view, the lack of competition in primary capacity markets will prevent FERC from lifting existing price caps on long-term capacity, which could introduce an additional degree of competition, but at a price that eliminates any benefits that could be realized.

Do current conditions permit the Department to place a greater reliance on competitive markets to ensure reliability?

As stated repeatedly in its prior Orders, the Department's primary concern with relying on competitive markets to provide needed reliability was the absence of a workably competitive upstream capacity market serving Massachusetts. Adequate market liquidity and a rapid response in the time, place, and manner by which capacity is constructed and contracted for are the key markers of whether a competitive market can ensure adequate capacity to reliably serve customers. When that analysis concludes that the upstream capacity market is sufficiently competitive, the Department should reevaluate the existing role of the LDC in capacity planning and contracting.

Are these key measures in place now? The Department is well aware of the important incremental capacity projects and capacity expansions that now provide additional deliverability to the New England region. These include PNGTS, Maritimes, Hubline, Distrigas expansion and

Tennessee expansion capacity. However, the majority of the expansion capacity has been used to serve incremental core loads or to fuel gas-fired electric generation. Gas-fired electric generation needs alone have grown by nearly 10,000 MW. Therefore, in Bay State's view, even with the considerable new capacity that has come online in the last five years, market liquidity has not measurably changed since the *1999 Capacity Order*.

Basis price differentials provide an important measure of market liquidity by assessing the ***value*** of capacity serving different markets. During the period of tight supplies during the 2000-01 winter, many regions of the country experienced unusually high basis differentials indicating that the delivery infrastructure into many major markets was constrained. During the most recent cold snap in January 2004, basis differentials in many areas of the U.S. were more moderate than in the 2000-01 winter. However, the New England basis differentials reached levels never experienced before -- indicating that capacity resources in this region remain scarce.

Another important factor to determine the ability of the market to provide independently for upstream capacity is the manner in which new deliverability is made available to the region. Even with the restructuring of interstate pipeline markets, LDCs and power generators remain the most likely to commit on a long-term basis for the vast majority of incremental and replacement pipeline capacity. As stated earlier, pipelines require long-term contracts in order to commit to dedicating capacity to a particular market.

Therefore, in Bay State's view, persistent capacity illiquidity in New England combined with continuing requirements for LDCs to hold contracts for capacity indicate that the market is not sufficiently competitive to maintain reliability. The complex and lengthy regulatory review process and substantial investment costs associated with new and expansion projects make it

difficult for the capacity supplies to respond to increases in market prices. Bay State believes the consequences in terms of reliability and price are too great for it to relinquish capacity planning responsibilities to market forces at this time. The indicators of a responsive market are not present. Bay State's own experience with significant numbers of transportation customers returning to default service demonstrates that the market is not mature, and the need for a supplier–of-last-resort is still a vital safety net so that all customers have safe, reliable and uninterrupted natural gas service to meet their needs. The Department should not modify the LDC's role in capacity planning and acquisition until key market indicators reliably justify a change.

Are there entities other than the LDC that could fulfill the existing capacity planning and procurement role?

In the absence of relying on markets to provide for reliability on their own, the next logical question is whether an entity other than the LDC could fulfill its existing role of ensuring adequate capacity exists and whether shifting to that entity would result in material benefits to customers. Answering this question requires an assessment of different aspects of the existing LDC role in capacity planning and procurement, including its interactions with the Department, customers and pipeline suppliers.

On a periodic but regular basis, the Department reviews the adequacy and cost of each LDC's supply and capacity resources. The Department's oversight role includes the approval of these periodic forecast and supply plans, as well as individual contracts with terms of more than one year. M.G.L. c. 164, 94A. It would be difficult to replicate the Department's oversight of capacity planning (and reliability) if the LDC were replaced by a third-party provider because as

of yet, the Department has plenary jurisdiction and oversight only over the LDC. Further, an enforceable reliability standard for marketers would have to be imposed to take the place of the standards now applicable to LDCs. Moreover, competitive market participants routinely resist sharing their proprietary supply plans with regulators, which would be necessary for proper monitoring. Without such plans or regulatory contingency, market forces may incent improper planning or allocation of available, constrained capacity. The only enforcement tool available to the Department currently would be the ability to revoke a competitive license, which is not comparable to the Department's authority over natural gas companies.[10] License revocation would do nothing to address the operational consequences for firm customers of a capacity shortfall.

In addition, without further market transition and in the market as it now exists, the LDC is able to capitalize on opportunities to achieve benefits for its customers in ways that third-parties can not. For instance, LDCs often achieve reliability enhancements through contract negotiations with pipelines, such as the agreement by a pipeline to construct a new gate station or to increase operating pressures as part of a deal to acquire new capacity. As the Department knows, Bay State has recently entered into such arrangements, resulting in savings and increased reliability and service for its customers.

Even though retail markets have been open to competition for approximately ten years in Massachusetts, competitive suppliers have not demonstrated a long-term commitment to the market by acquiring, for example, firm primary delivery point capacity to LDC citygates. The LDC remains the only, and the logical, choice to continue capacity planning and acquisition at

[10] Moreover, LDCs are directly motivated to protect hundreds of millions of dollars worth of investment in distribution infrastructure, the value of which is directly related to the reliability of service the LDC is able to provide to customers.

least until other participants are willing and able to demonstrate a long-term commitment to customers and the region's economy. LDC's will unquestionably maintain the reliability of the upstream portfolio because distribution service reliability – its core business interest -- is wholly dependent upon adequate upstream capacity.

Are there any risks associated with voluntary assignment in today's market environment?

Bay State believes a number of material risks exist in a voluntary assignment environment relating to (1) reliability and (2) cost consequences for consumers. Were upstream markets sufficiently competitive, as is the case elsewhere, the risks would be easier to manage. This is why other jurisdictions may have deemed voluntary capacity assignment to be reasonable, while the Department decided initially to adopt mandatory assignment.

The greatest potential risk associated with voluntary assignment is that reliability may be jeopardized. Given the brief tenures of most marketers that have served Bay State's customers, the potential for a deliverability incident is well within the realm of reason. In fact, the significant reverse migration of customers whose marketers opted not to take Bay State's capacity as permitted under its pilot programs posed a considerable reliability risk to Bay State. As supplier of last resort, Bay State was required to provide reliable service even though it was impossible to reacquire the necessary capacity from the suppliers who returned the customers to Bay State.

It should be noted, even though the risks abounded, the most vibrant reverse migration occurred during the 1998 - 2001 time period, which was just after Bay State acquired incremental capacity on PNGTS and just prior to the time it was required to provide notice to Tennessee regarding capacity renewal. Sheer luck and opportunity combined in order for Bay

State to avoid problems and compromises in the reliability of its service attributable to marketer decisions to stop serving its customers. Had the trend shifted from forward to reverse migration a year or 2 earlier, it is quite possible Bay State would not have been able to acquire capacity needed to maintain the Company's design weather planning criteria for the 1998-99 winter heating season because no alternatives were available.

Another way that reliability might be jeopardized through voluntary capacity release is if marketers employ less-than-design planning criteria to construct their portfolios or rely on interruptible or secondary firm capacity to meet firm customer requirements, which might not be scheduled during periods of peak demand. Other than a brief period during the 2000-01 winter and again this January, extreme cold snap weather conditions have not been experienced since Bay State implemented its residential pilot program in 1996, preventing a real test of marketer performance under extreme conditions. This is particularly true for marketers serving Bay State's residential customers because most of these customers were returned to Bay State during the cold weather period of 2000-01.

Voluntary assignment also poses cost risks for Massachusetts gas consumers. As marketers elect not to take utility capacity, the remaining utility capacity is devalued. The devaluation is magnified as the utility must mitigate the fixed costs of any unelected capacity by releasing it into the secondary market. The additional capacity available in the secondary market reduces the revenues realized by LDCs for capacity release and off-system sales activities associated with capacity needed to serve sales customers as well. Voluntary assignment also increases the costs of the supplier-of-last-resort function as a result of the need to maintain contracting flexibility to meet the potential capacity requirements of transportation customers in

the event that they return to default service. Bay State documented this phenomenon in its most recent Integrated Resource Plan.

Mandatory assignment with the opportunity for marketers to influence LDC capacity decisions through the consultative approach previously adopted by the Department represents a superior alternative to voluntary capacity assignment. Involving market participants in the decision-making process at the time capacity decisions are initially made is superior to allowing them to undo the benefits of those decisions through voluntary assignment.

Is mandatory assignment an impediment to the development of competitive retail markets?

The economic rationale for and against mandatory capacity assignment has been well documented in prior proceedings before the Department, including D.T.E. 98-32. The Department's *1999 Capacity Order* provides an adequate review of the topic, which Bay State need not repeat here. However, Bay State can offer the Department its own perspective on the question based on its practical experience offering transportation programs that offered voluntary assignment of capacity versus those programs that offered mandatory assignment.

Bay State's 1996 residential pilot program began with voluntary assignment in an effort to draw as broad a group of marketers as possible to the program. Other elements of the program were marketer-friendly as well, including the use of rolling enrollment beginning in the second year of the pilot. D.P.U. 104-C. At its peak, approximately 23,000 residential customers were served under the pilot. The majority of marketers serving these customers elected not to take Bay State's customers. When the Department approved the Model Terms and Conditions implementing its mandatory capacity assignment policy, all customers with voluntary capacity were grandfathered from any capacity assignment responsibility for as long as they remained

transportation customers. D.T.E. 98-32-D. Virtually all pilot residential customers were returned to Bay State default service regardless of whether they had capacity or not. If voluntary capacity assignment were the critical factor to the development of competitive retail markets, suppliers serving grandfathered customers should have been able to monetize the associated benefits by selling their book of customers to another marketer rather than returning the customers to default service, which is what occurred.

These data suggest that other factors have contributed to the slow and uneven development of competitive retail markets, and that the introduction of voluntary assignment by the Department at this time would have very little effect, if any, on the competitive alternatives available to residential customers. One factor that has had a negative impact on the development of retail competition has been a dramatic decline in available capital to fund energy marketing operations, both retail and wholesale.

The conclusion drawn from Bay State's experience is that competition under voluntary assignment is not promoted more on any measurable scale than under mandatory assignment. When the potential risks of voluntary assignment are taken into consideration along with Bay State's actual experience, the Company believes that the potential negative impacts of voluntary assignment outweigh the potential benefits.

Are prices paid by consumers affected by the Department's approach to capacity planning and assignment?

The Department's capacity assignment policy is intertwined with the capacity planning responsibilities of LDCs and other market participants. The Department has long recognized the impact of resource planning upon consumer prices. On a regular basis, the Department reviews

the adequacy and cost of utility supply plans through integrated resource plan proceedings that investigate all cost implications of LDC resource planning decisions. See e.g., Bay State Gas Co., D.T.E. 02-75 (2004). The purpose of these reviews is to ensure that customers receive the required level of service at the lowest possible cost through appropriate capacity decisions.

Retaining the LDC's role in capacity planning ensures that it is able to continue to acquire the lowest cost capacity resources in order to maintain its competitive position with other fuel choices. LDC planning considers the long-term portfolio costs of each decision to contract, to renew or to de-contract capacity. Competitive suppliers may not pursue the best-cost alternative if it would result in a longer-term commitment than business goals may dictate in the short-term. In such cases, the LDC may be forced to acquire higher-cost capacity if customers return to default service when market conditions are tight.

In addition to these factors related to capacity planning, the capacity assignment method also influences consumer prices as previously discussed. Prices could rise in the event that existing capacity is undervalued by the need for LDCs to mitigate the fixed costs of unelected capacity under a voluntary capacity assignment method.

What factors are most relevant to any future change to the Department's capacity assignment policy?

The Department should continue to evaluate the competitiveness of both upstream capacity markets and retail markets in order to determine whether its capacity assignment policy should be reevaluated in the future. Bay State believes that reexamination should be premised on market status, transition and growth rather than a predetermined time period. Activity in retail competition in Massachusetts has flattened from activity levels exhibited prior to 2001.

Reexamination of the Department's capacity assignment policy may be more appropriate in a five-to-seven year time-frame, however this is wholly dependent upon the level of future market development.

Bay State recommends that the Department establish a series of signposts to be monitored that will assist in determining whether its policies should be revisited. These signposts include: (1) an examination of the proportion of firm capacity rights on pipelines serving Massachusetts held by competitive suppliers; (2) a constant monitoring of trends in forward migration, especially in gas and electric markets that are not presently served by competitive suppliers, i.e. residential markets ; and, (3) a continuing review of FERC activities to determine whether federal policies can assist in relieving retail markets of some of the barriers contributing to the current lack of competition in upstream capacity markets in this region of the United States.

IV. SUMMARY OF BAY STATE GAS COMPANY RECOMMENDATIONS

Much has transpired since the Department issued its initial Order addressing capacity in early 1999. Many of the events and market responses were far from being anticipated, however. Instead of an orderly transition to competitive markets, progress has come in fits and spurts and is uneven across Massachusetts retail gas markets. Tightening supply, increased price volatility, supplier exits particularly from residential markets, electricity blackouts, and the financial collapse of wholesale trading operations have all contributed to a recalibrated outlook concerning the future development of competitive retail markets. The benefits of competition remain worthy

of continued pursuit, but the road to achieving those benefits is longer and perhaps much more circuitous than originally anticipated.

At the same time, many of the underlying market fundamentals remain largely unchanged from those that existed in early 1999. The lack of competitive upstream capacity markets persists. Growth in demand, especially in the gas-fired electric generation sector, continues to outpace new supply and delivery infrastructures. LDCs continue to hold the vast majority of primary pipeline capacity rights not used by electric generators. Current market conditions and experience indicates that the course mapped out by the Department continues to be appropriate for the foreseeable future. Specifically, the Department should continue to hold LDCs responsible for the capacity planning and acquisition to serve customers on a reliable basis. Additionally, the Department should continue mandatory assignment of capacity to suppliers based on the Model Terms and Conditions approved in 2000.

Capacity planning and acquisition should remain the responsibility of Massachusetts LDCs.

Successful progress toward the development of competitive retail markets for all Massachusetts consumers requires that reliability remain uncompromised. While new pipelines are serving the New England region, upstream capacity markets remain uncompetitive due to the substantial incremental gas-fired electric generation and a lack of local market area storage accessible through interstate pipelines. Competitive supplier activity appears to have leveled off with competition virtually limited to C&I customers. Under these circumstances, the Department should continue to require LDCs to identify and contract for the capacity needs of their customers, subject to existing Department oversight.

Bay State's experience with its customer choice pilot programs and implementation of full customer choice supports the critical need for adequate capacity planning and acquisition to meet the uncertain future requirements as customers migrate to and from transportation services. Current market conditions do not allow for reliance on market forces to independently provide for reliability nor are other market participants sufficiently vested in individual markets for a long-enough term to assume the LDC's existing role. The Department should continue its current practice of requiring LDCs to fulfill the role of acquiring capacity. The Department's consultative process ensures that market participants have the opportunity to influence the LDC's decision-making process prior to acquiring new capacity resources.

Capacity should be assigned on a mandatory basis to customers.

Mandatory capacity assignment is the most effective means of ensuring reliability for customers. Mandatory capacity assignment avoids potential reliability and cost risks associated with voluntary capacity assignment. Voluntary assignment would allow marketers to undo the benefits of the LDC's capacity decisions and lead to higher costs borne by customers. These costs include unmitigated fixed costs associated with unelected capacity and higher supplier-of-last-resort costs incurred to provide for resource flexibility to meet potential reverse migration of customers without capacity necessary to serve them.

Bay State's unbundling experience indicates that mandatory capacity assignment is not an impediment to market activity. The Company's grandfathered transportation customers, including more than 37,000 residential customers, have migrated back to default service demonstrating that factors other than capacity assignment methods stand in the way of retail competition for small volume customers. The LDC should continue capacity planning and

acquisition at least until other participants are willing and able to demonstrate a long-term commitment to customers and the region's economy. Distribution service reliability relies upon upon adequate upstream capacity.

Respectfully submitted,

BAY STATE GAS COMPANY

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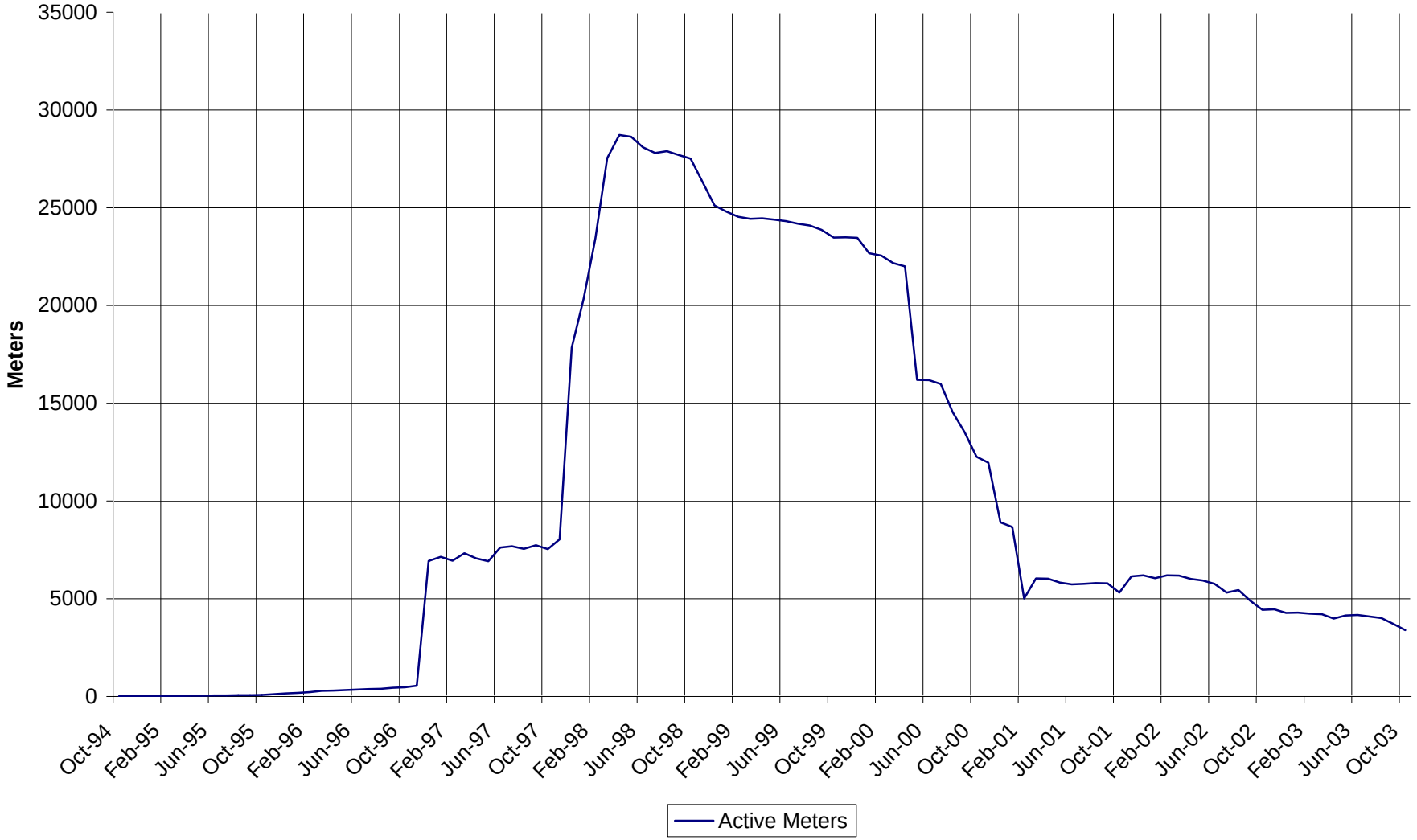
BAY STATE GAS COMPANY
D.T.E. 04-01

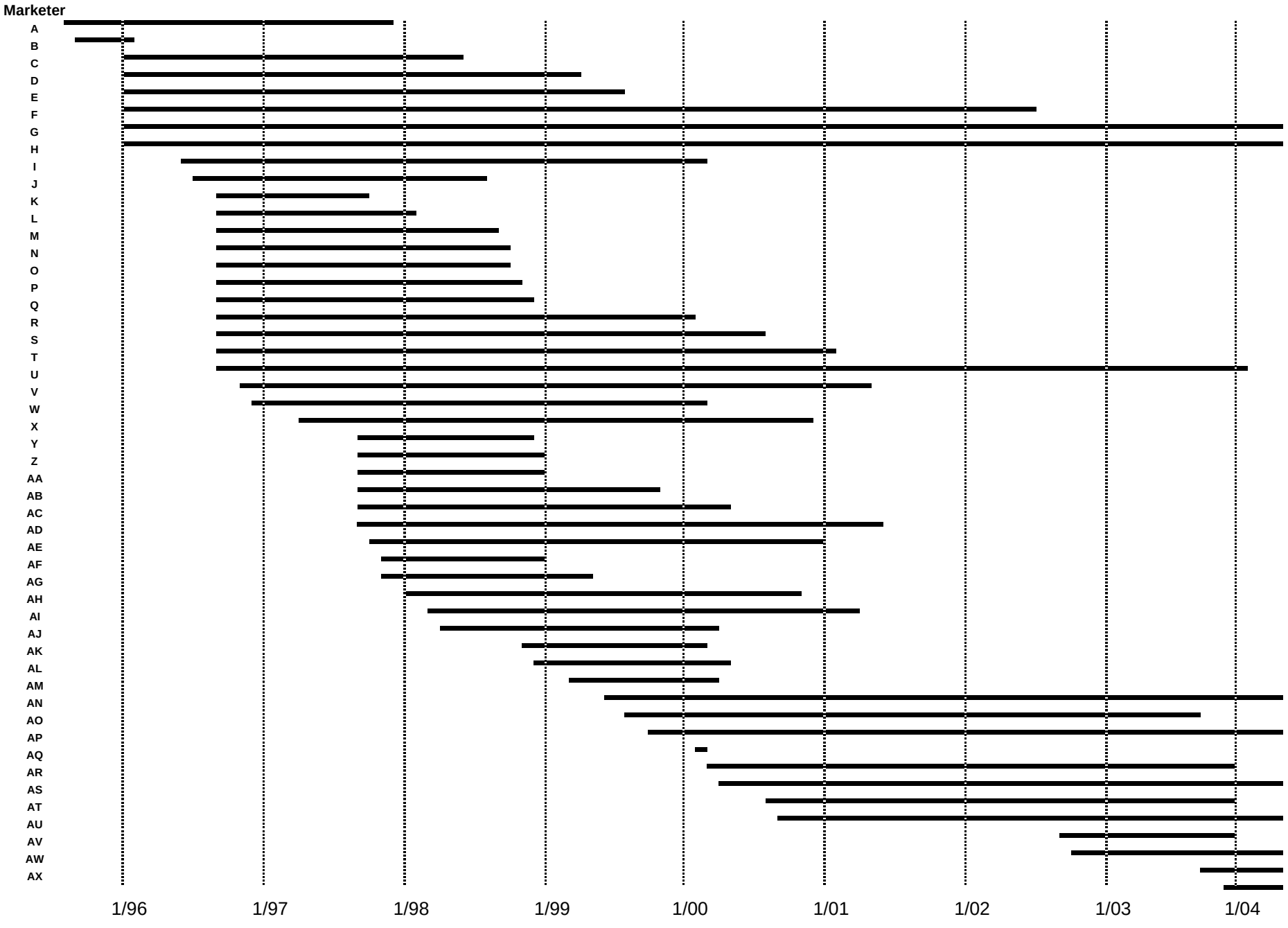
Figure 1
Transportation Active Meters



D.T.E. 04-01

Figure 2

Duration of Marketer Activity on Bay State Gas Company System



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D.T.E. 04-01

Figure 3
Comparison of New England and Chicago Basis vs. Heating Degree Days